

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:NJD:NEW:TL-N-2045-99
AAMmirato

date: APR 16 1999

to: Chief, Examination Division, New Jersey District

from: District Counsel, New Jersey District, Newark

subject: [REDACTED] - Interest Accrual
U.I.L. 461.07-00; 461.08-00

This responds to your request for advice on the merits of the taxpayer's argument concerning the proper timing of deductions for statutory interest on federal income tax liabilities.

DISCLOSURE STATEMENT

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This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

BACKGROUND/FACTS:

Revenue Agent [REDACTED] provided us with the taxpayer's argument concerning the proper timing of deductions for statutory interest on federal income tax liabilities. Specifically, the significance of the execution of Form 870. The taxpayer argues that the execution of Form 870 "has significance for accrual purposes only if the taxpayer first has taken some other affirmative action to signify its intention to contest the

liability". The taxpayer's argument does not pertain to any particular tax adjustments but to adjustments in general in the taxable years [REDACTED] through [REDACTED]. Since we were not provided with any facts of a specific adjustment, this advisory is limited to a general discussion of the current law in this area.

ISSUE: Whether statutory interest on a tax deficiency is deductible by an accrual basis taxpayer in the tax years prior to the year the taxpayer signs a Form 870?

The answer depends on whether the liability for the tax deficiency was contested by the taxpayer prior to signing a Form 870.

RULE/ANALYSIS:

I.R.C. Section 446(a) provides that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." An accrual method taxpayer is entitled to a deduction for a liability when: 1) "all events" have occurred that establish the fact of liability (liability is "fixed"); 2) the amount of liability can be determined with reasonable accuracy; and 3) economic performance has occurred with respect to the liability. Treas. Reg. 1.461-1(a)(2)(i); I.R.C. section 461(h)(4). Liability for an income tax accrues at the close of the "income year" since that is the time at which "all events have occurred which fix the amount of the tax". U.S. v. Anderson, 269 U.S. 422, 441 (1926); National Forge & Ordnance Co. v. U.S., 158 F.Supp. 860 (Ct. Cl. 1958) (The liability for income taxes becomes "fixed" at the close of the respective taxable year in the amount eventually determined to be due, unless the liability for an additional amount is contested).

A contested tax liability is not "fixed" and therefore, cannot be accrued. Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1943); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944) (A taxpayer may not accrue an expense, including a tax, the amount of which is unsettled or the liability for which is contingent). Once the taxpayer agrees to the liability it becomes fixed and accrues at such time. Id. Liability for interest on the contested liability becomes fixed at the same time as the tax. See H.E. Harman Coal Corp. v. Commissioner, 16 T.C. 787, 806-07 (1951).

The taxpayer is correct in arguing that the execution of a Form 870 signifies the first year of accrual of statutory interest on a tax deficiency only if the liability was contested. Therefore, the pertinent issue is what constitutes a "contest". To determine whether a proposed tax was contested all the facts

and circumstances surrounding the particular tax adjustment must be considered. Phillips Petroleum Co. v. Commissioner, T.C. Memo. 1991-257. A "contest" requires some objective act of protest or affirmative evidence of denial of liability by the taxpayer. Dravo Corporation v. United States, 348 F.2d 542 (Ct. Cls., 1965); Rev. Rul 70-523, 1970-2 C.B. 105; Rev. Rul. 68-631, C.B. 1968-2; Treas. Reg. 1.461-2(b)(2) (It is not necessary that the affirmative act denying liability be in writing if upon examination of all the facts and circumstances, it can be established to the satisfaction of the commissioner that a liability has been asserted and contested). It is well settled that lodging a formal protest with a tax authority or instituting a suit constitutes a contest. Rev. Rul. 68-631, 1968-2 C.B. 198. In addition, a disagreement with a revenue agent's findings as set forth in the Revenue Agent's Report (RAR) and notifying the District Director that a district conference is requested constitutes a contest. See Rev Rul. 72-306, 1972-1 C.B. 165. However, the mere filing of a return showing a liability in a stated amount is not the equivalent of a contest by the taxpayer to a proposed tax deficiency. Dravo Corporation v. United States, 348 F.2d 542 (Ct. Cls., 1965); Rev. Rul 70-523, 1970-2 C.B. 105; Rev. Rul. 68-631, C.B. 1968-2.

The courts recognize that "a taxpayer may resist payment of an asserted claim in more subtle ways than express denial of liability or adoption of a litigious attitude". Phillips Petroleum Co. v. Commissioner, T.C. Memo. 1991-257, citing, General Communication Co. v. Commissioner, 33 T.C. 640 (1960). In Phillips Petroleum Co., the court held that the proposed tax deficiencies were contested and therefore, accrued in the year that a Form 870-AD was signed. The case involved the audit of the petitioners 1970 through 1978 taxable years. The revenue agent issued Forms 5701, Notice of Proposed Adjustments, to the taxpayer. The taxpayer did not check any of the boxes on the Forms.¹ The revenue agent eventually issued RAR's which became the basis of letters 950(DO) ("30 day letters"). The petitioner timely filed formal written protests to each of the 30 day letters. However, these protest letters discussed some, but not all, of the proposed adjustments for the years involved. The letters were silent as to the remaining issues (the unprotested adjustments). The petitioner finally signed Form 870-AD during an appeals conference which disposed of all issues. The petitioner argued that the unprotested adjustments were uncontested and

¹Form 5701 provides boxes which allow the taxpayer to indicate: a) agreed; b) agreed in part; c) disagreed; and d) have additional information to submit with regard to the proposed adjustment.

therefore accruable during the adjustment years. The court held that the proposed adjustments were sufficiently challenged by the taxpayer's nonacquiescence to render them contested. The court pointed out that the taxpayer had ample opportunity during the examination to agree to the proposed deficiencies. The taxpayer did not and therefore, retained its complete right to protest until Form 870-AD was signed.

Again, we would need the facts surrounding a specific tax adjustment to provide advice regarding the proper timing for the accrual of statutory interest on such liability. If you have any questions please contact attorney Anthony Ammirato at (973) 645-2539. Please note that this advice has been sent the National Office for post review.

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By:

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